

Message Text

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E.O. 11652: GDS
TAGS: EFIN, EGEN, PE
SUBJECT: PERUVIAN FINANCIAL SITUATION

1. SUMMARY: IMF TEAM REVIEW OF GOP COMPLIANCE WITH STANDBY INDICATES GENERAL ADHERENCE TO TARGETS EXCEPT FOR EXCHANGE RATE: OFFICIAL RATE OF 130/S MAINTAINED THROUGH "GENTLEMEN'S AGREEMENT" AMONG BANKS IS WELL BELOW CD RATE OF 160 OR MORE THERE ARE ALSO SOME QUESTIONS ABOUT BUDGET TARGETS, BUT THESE APPEAR UNLIKELY TO CAUSE MAJOR PROBLEMS AT THIS TIME. APPARENTLY GOP WILL HAVE TO MAKE ADJUSTMENTS IN EXCHANGE RATE POLICY (WHICH COULD PROVE DIFFICULT POLITICALLY) BEFORE IMF MANAGEMENT WILL PERMIT DRAWING OF SECOND TRANCHE OF STANDBY (AVAILABLE AS OF MARCH 1). MEANWHILE COMMERICAL BANK \$260 MILLION LOAN PACKAGE REMAINS CONTINGENT ON SECOND TRANCHE DRAWING. OUTLOOK IS FOR GOP TO RESOLVE EXCHANGE RATE PROBLEM WITH IMF OVER NEXT WEEK OR TWO SO AS TO ENABLE CONCLUSION OF COMMERICAL BANK LOAN BY END MARCH EARLY APRIL. HOWEVER, THERE IS UNEASINESS HERE THAT DELAY AND INDECISION BY GOP COULD JEOPARDIZE COMMERICAL BANK PACKAGE. END SUMMARY.

2. IMF TEAM HEADED BY LINDA KOENIG RECEIVED FULL COOPERATION OF GOP DURING ITS TWO AND A HALF WEEK STAY ENDING
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FEBRUARY 28. IN THE PAST, IMF CONSULTATIONS HAVE BEEN LIMITED PRIMARILY TO MINISTRY OF FINANCE AND CENTRAL BANK WHILE THIS TIME KOENIG HAD MEETINGS WITH MINISTERS OF INDUSTRY AND COMMERCE, ENERGY AND MINES, COMMUNICATIONS AND TRANSPORT, AND FOOD AND AGRICULTURE AS WELL.

3. RESULTS OF IMF MISSION ARE RENEWED COMMITMENT GO GOP

TO PURSUE ECONOMIC STRATEGY WORKED OUT WITH IMF LAST OCTOBER, GENERALLY GOOD MARKS FOR COMPLIANCE THUS FAR, BUT WITH ONE GLARING EXCEPTION: EXCHANGE RATE POLICY. UNDER CURRENT PROCEDURES, THE OFFICIAL RATE OF 130/S IS MAINTAINED THROUGH A "GENTLEMEN'S AGREEMENT" AMONG LEADING BANKS, INCLUDING GOP'S BANCO DE LA NACION, WHILE THE FREELY FLOATING CERTIFICATE OF DEPOSIT (CD) RATE IS AT 160/S OR HIGHER. DESPITE CLAIMS BY THE CENTRAL BANK THAT THESE REATES REPRESENT "SPOT" AND FUTURES" MARKETS AND THUS ARE NOT IN VIOLATION OF IMF ACCORD, THE IMF TEAM APPARENTLY DISAGREES. IF AS WE ANTICIPATE THE FINAL IMF MANAGEMENT JUDGMENT IS THAT THE RATE STRUCTURE IS CONTRARY TO THE ACCORD, THE GOP CANNOT DRAW DOWN THE SECOND TRANCHE OF THE STANDBY UNTIL IT ADJUSTS ITS EXCHANGE RATE POLICY.

4. THERE ARE ALSO SOME QUESTIONS ABOUT BUDGET REVENUE AND EXPENDITURE TARGETS FOR 1978. THE IMF REPORTEDLY FEELS THAT FURTHER ADJUSTMENTS IN THE ORDER OF 15 BILLION SOLES WILL BE REQUIRED DURING THE COURSE OF THE YEAR TO REACH THE TARGET OF A 35 BILLION SOL NET BORROWING REQUIREMENT FOR THE PUBLIC SECTOR. A RELATED FACTOR IS THAT INFLATION IN 1978 WILL LIKELY BE HIGHER THAN 20 PERCENT IN THE IMF PROJECTION (PARTICULARLY IF THE EXCHANGE RATE IS ALLOWED TO FLOAT HIGHER), WHICH WOULD LIKELY IN TURN RESULT IN SOME FURTHER WAGE ADJUSTMENTS. THESE ADJUST-
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MENTS, HOWEVER, WOULD HAVE LARGELY OFFSETTING EFFECTS ON BUDGET TARGETS (E.E., INFLATION INCREASES TAX REVENUES WHILE WAGES INCREASE EXPENDITURES). PRIVATE BANKING SOURCES TOLD US THERE IS A BUDGET RELATED PROBLEM WITH HOW THE ROLLOVER OF JANUARY SOVIET DEBT WAS TREATED WITH RESPECT TO BUDGET CEILINGS, BUT WE ARE NOT SURE WHETHER THIS IS PART OF THE IMF PROBLEM WITH THE BUDGET OR SOMETHING ADDITIONAL. IN ANY EVENT, OUR CURRENT READING IS THAT IMF MANAGEMENT IS NOT REPEAT NOT GOING TO MAKE BUDGET PROJECTIONS A MAJOR PROBLEM FOR GOP DRAWING OF SECOND TRANCHE.

5. PRIVATE BANKER ALSO NOTED POSSIBLE TECHNICAL DIFFICULTIES WITH THE NET INTERNATIONAL RESERVE TARGET, ALTHOUGH HE CHARACTERIZED THEM AS NO REAL PROBLEM AND THE IMF TEAM HAD NO APPARENT DIFFICULTY ON THIS SCORE.

6. THE MOST IMMEDIATE ISSUE THEREFORE IS RESOLUTION OF THE EXCHANGE RATE ISSUE SO THAT GOP CAN DRAW THE SECOND TRANCHE OF THE STANDBY (AVAILABLE AS OF MARCH 1). THE MOST LIKELY RESOLUTION WOULD BE TO ALLOW THE OFFICIAL RATE TO RISE, BY INCREMENTS OR THROUGH A RESUMED FLOAT.

THERE WOULD BE POLITICAL OPPOSITION TO THIS, HOWEVER, WITHIN THE GOVERNMENT AND FROM OPPOSITION GROUPS. THE IMF TEAM WAS ROUNDLY CRITICIZED IN BOTH THE INDEPENDENT POLITICAL MAGAZINES AND THE CONTROLLED DAILY PRESS. THE 7.5 PERCENT PRICE RISE IN JANUARY (AND LIKELY BIG JUMP AGAIN IN FEBRUARY) ARE LINKED TO WHAT MANY FEEL UNWISE ACCEPTANCE BY THE GOP OF IMF FLOATING RATE DOCTRINE WHICH HAS ALLEGED PERVERSE EFFECTS ON THE PERUVIAN ECONOMY. ALTERNATIVES OPEN TO THE GOP HOWEVER ARE LIMITED. A RENEGOTIATION OF THE IMF ACCORD WITH AN ALTERNATIVE EXCHANGE RATE COMMITMENT WOULD BE A LENGTHY PROCEDURE UNLIKELY TO SUCCEED. A SWITCH FROM THE IMF ACCORD TO SOME OTHER NON-IMF ARRANGEMENT FOR RESTRUCTURING EXTERNAL DEBT PAYMENT WOULD UNDERMINE COMMERCIAL CONFIDENCE AND PERHAPS

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CAUSE THE FALL OF THE MORALES BERMUDEZ REGIME.

7. NEVERTHELESS, THE GOP IS APPARENTLY STILL UNDECIDED IN ITS RESPONSE TO THE EXCHANGE RATE PROBLEM AND PROLONGED DELAY COULD HAVE NEGATIVE REPERCUSSIONS ON THE \$260 MILLION COMMERCIAL BANK LOAN UNDER NEGOTIATION IN NEW YORK. THIS LOAN IS TIED TO GOP DRAWING OF THE SECOND TRANCHE OF THE IMF STANDBY. THERE IS NERVOUSNESS BY SOME BANKERS THAT DELAY OR LOSS OF MOMENTUM IN FINAL AGREEMENT ON THIS LOAN (WHICH IS STILL INCOMPLETE WITH RESPECT TO THE TERMS OF THE LOAN AND PARTICIPATION BY SMALLER BANKS) COULD RESULT IN AN UNRAVELLING OF THE PACKAGE. AT LEAST ONE MAJOR BANK, MORGAN GUARANTY, IS GENERALLY DISPLEASED WITH THE COMMERCIAL BANK PACKAGE, AND IS INDICATING A PREFERENCE FOR THE PARIS CLUB APPROACH SO THAT OFFICIAL AS WELL AS PRIVATE LOANS CAN BE RENEGOTIATED.

8. COMMENT: THE MOST LIKELY SCENARIO IS FOR THE GOP TO TAKE A DECISION IN THE NEXT WEEK OR SO TO ALLOW THE EXCHANGE RATE TO MOVE UP FROM 130 AND THUS QUALIFY TO DRAW THE SECOND TRANCHE OF THE IMF STANDBY BY MID-MARCH. THIS COULD PERMIT CONCLUSION OF THE COMMERCIAL BANK LOAN BY LATE MARCH-EARLY APRIL. THE RELATIVELY SUCCESSFUL HANDLING BY THE GOP OF THE FEBRUARY 27-28 GENERAL STRIKE (I.E., SMALL STRIKE EFFECTIVENESS WITH MINIMAL POLICE REPRESSION) SHOULD STRENGTHEN THE POSITION OF THE GOP TO MAKE AN UNPOPULAR DECISION ON THE EXCHANGE RATE.

9. A BROADER QUESTION FOR FUTURE MONTHS IS THE OUTCOME OF LETTING THE SOL FLOAT. EVEN THE FUND STAFF MAY BE NERVOUS AS TO HOW HIGH THE RATE WILL GO, AND TO WHAT

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EXTENT THIS WILL TRIGGER A TYPER-INFLATION MENTALITY,
AND PERHAPS REALITY.
SHLAUDEMAM

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